

Private Sector Priorities for Basel Reform

TESTIMONY OF D. WILSON ERVIN

on behalf of

Credit Suisse First Boston

and

The Financial Services Roundtable

**Hearing on Basel Capital Reforms
House Committee on Financial Services
Subcommittee on Financial Institutions & Consumer Credit
September 28, 2005**

Testimony of D. Wilson Ervin
Hearing on Private Sector Priorities for Basel Reform
House Committee on Financial Services
Subcommittee on Financial Institutions & Consumer Credit
September 28, 2005

Introduction

Good morning Mr. Chairman. I want to thank you for holding these hearings today and inviting me to appear before the Committee. My name is Wilson Ervin and I am a Managing Director of Credit Suisse First Boston ("CSFB").¹ I currently am head of CSFB's Strategic Risk Management department and have been named to be the Chief Risk Officer for Credit Suisse effective at the end of the year. I am presenting testimony today on behalf of CSFB and on behalf of our trade group, the Financial Services Roundtable.² CSFB employs approximately 20,000 people, primarily in the United States, and is a major participant in the capital markets. It ranks among the top firms in raising money for companies around the world and is a leading underwriter of mortgage and credit card financing. The firm is also among the largest managers of funds invested in private companies.

My responsibilities include assessing the risk profile of CSFB on a global basis and recommending corrective action where appropriate to protect our capital. This objective is similar to many of the goals of bank supervisors, including the drafters of the proposed Basel Accord – to deter large losses and protect bank solvency.

¹ Credit Suisse First Boston (CSFB) is a U.S. financial holding company and leading global investment bank serving institutional, corporate, government and high net worth clients. CSFB's businesses include securities underwriting, sales and trading, investment banking, private equity, financial advisory services, investment research, venture capital and asset management. CSFB operates in more than 89 locations across more than 37 countries on six continents. The Firm is a business unit of Zurich-based Credit Suisse Group, a leading global financial services company.

² The Financial Services Roundtable is a national association representing 100 of the largest integrated financial services companies in the U.S. providing banking, insurance, securities, and investment products and services to American consumers.

The Basel II Capital proposals have been the topic of intense discussion and debate in the financial and regulatory community for the past several years. The industry supports the objectives of the Basel process: to better align regulatory capital to underlying economic risks, promote better risk management and foster international consistency in regulatory standards. The proposed Accord is not a minor refinement to the bank regulatory process, but is, instead, a wholesale reform of bank regulation – a regime that covers roughly \$2 trillion of capital and is a key economic engine for most developed markets. The impacts of these seemingly technical discussions will affect banks, the markets and the economy in a deep way, and this committee is prudent to consider the effects carefully before implementation.

Before I start, I would like to note that I have personally developed tremendous respect for the diligence and stamina of the regulators who have worked on Basel II, as well as the review done by Congress. They have had to address a great many complex and challenging issues, and have been tenacious in trying to develop a “best practice” solution for each. Balancing all of this and applying it to very different financial markets around the world – with political sensitivities in each – does not make this an easy job. I wish to express appreciation for the efforts of Federal Reserve Board Governor Bies and Vice Chairman Roger Ferguson, who have met with CSFB and Roundtable member companies on several different occasions to listen to our concerns on the proposed Accord. The OCC, FDIC and OTS have also had open doors for discussion throughout the long process of developing the new Accord.

CSFB and the Roundtable have worked hard to be constructive commentators on the new rules, particularly in respect to practical implementation issues. The proposal has been continually evaluated and the regulators have demonstrated a willingness to address specific issues raised by industry and academic critics. We support the direction in which the Accord has moved, and appreciate the regulators’ willingness over time to reexamine earlier conclusions and consider further changes.

Basel II has considerable momentum, and most people in the industry believe it will likely be implemented in the relatively near future. However, as in all complex undertakings, the Basel document in its current state is not perfect. On balance, we believe that the advantages of the reform substantially outweigh the drawbacks, but further improvements are still possible and desirable.

Today, without getting too involved in the technical details of the Accord, I would like to highlight three issues that we believe are particularly important as the Accord moves forward:

1. The Accord features some recently developed capital treatments for a bank's trading book. We are concerned that some of these new rules – specifically, those dealing with the calculation of a default risk capital charge for trading book positions - have been expressed in fairly general terms to date and are benchmarked against an inappropriate banking book standard. We are hopeful that we can see a memorialization of the verbal guidance already provided by regulators on where they are heading on certain key features. We also hope that the timetable for implementing this new calculation can be separated from the rest of the Accord, to allow for proper impact testing and careful implementation.
2. The regime for cross-border implementation of the Accord is not yet fully transparent. While an Accord Implementation Group has been established to deal with the so-called home-host issues, there has been painfully little tangible guidance, particularly for dealing with regulators in smaller countries not directly participating in the Basel process. The home-host issue with respect to the allocation of operational risk charges across jurisdictions is just one example of the need for greater clarity on cross border implementation. It is also important for the U.S. and the other G10 countries to conduct home-host regulation on a basis of real comity. We cannot afford duplication, waste or needless divergence.
3. The Accord is a complex document and there is a need for flexibility from all regulators if it is to be implemented successfully. Regulators will need to work with each other, as well as regulated institutions, to construct principles-based solutions under Pillar II of the Accord to address developments that don't fall neatly under the black-letter requirements of Pillar I. Regulatory transparency, communication and international coordination are key to this effort, together with continued Congressional Oversight, to ensure that the application of Basel II in practice is consistent with the original principles behind the reforms.

Trading Book Review

The first topic I want to discuss is the recently completed Trading Book Review. For several years now, the discussion regarding Basel II has focused principally on credit risk capital, and this area has been continually reviewed and reshaped based on an open, transparent process. For a combination of reasons, it was recently determined that a separate discussion of capital charges for market risk inherent in the traded credit and equity portfolios would also be necessary. With this in mind, a process was begun last year whereby the regulators and the industry entered into a cooperative dialogue through the BIS and IOSCO to address these issues

Because of the tight timetable, the new trading book proposals involving market risk (referred to as “Strand 3” of the Trading Book Review) have been designed and evaluated over a period of months, rather than the period of years that other parts of the Accord have been subject to. This contrasts sharply with the other “Strands” of the Trading Book Review, such as the work on counterparty credit risk, where the requirements have been subject to extensive development and dialogue with industry practitioners. The first draft on the new trading book standards was seen in April with one round of comment and a final version in July. Not surprisingly, there remain areas where regulators and the industry recognize that continued refinement will be necessary.

During the development stage, regulators have held a number of sessions with the industry to discuss certain problems found in the trading book drafts on market risk and to give the industry comfort in a critical area of the Accord. In these sessions, members of the BIS-IOSCO Working Group provided helpful guidance on their specific intentions related to the draft text. Industry members appreciated this clarification greatly and concluded that the rather general final language could work in practice with the interpretation that they heard directly from senior regulators.

Given the reliance placed by firms on the information provided in these sessions, we believe that it makes sense to record a common understanding of what was communicated. The industry has requested a memorialization of the understandings from the working sessions from the regulators, and we are optimistic that we will see such an affirmation in the relatively near future. We are aware that regulators plan to conduct further work in consultation with industry to flesh out the conceptual thinking in this area, and we are not seeking to pre-empt this review in any manner. However, we do believe that confirmation of the underlying understandings that were publicly discussed will assist regulators, industry associations, and firms to work on the basis of a consistent and clear understanding across firms and across jurisdictions, in accordance with the Working Group's intentions. This will ensure transparency of the regulators' intentions and gives industry participants greater confidence to move forward with the investments required to begin implementation of the trading book standards.

In addition, it is also worth noting that the new trading book requirements have only recently been published and that there remains work to be done to flesh out how they should be implemented in practice. In addition, no comprehensive impact assessment has been performed to date, and we believe this is a key gap that should be closed. We suggest that all regulators take advantage of the existing provision deferring the effective date until 2010 for this section of the Accord, so that refinement, impact analysis and final implementation can be done in an orderly, consistent manner. This timetable could be separate and apart from the rest of the Trading Book Review and the bulk of the final Accord.

Home/Host Country Issues

The second topic I would like to address is the complexity of the new rules, which pose particular challenges for an international bank that is regulated by supervisors in multiple countries. CSFB, for example, will be required to implement Basel II as a Swiss bank, a U.S.

financial holding company, a U.K. bank, and a regulated financial institution in 30 plus other countries. Our implementation will be governed primarily by the Swiss Federal Banking Commission, in conjunction with the Federal Reserve in the U.S. and the Financial Services Authority in the U.K., and also by other regulators around the world.

Most international banks face a similar set of interlocking regulation, in which both home and host countries interpret and enforce rules. This can give rise to conflicts, even under an international standard like the Basel Accord. At times, we have been given conflicting requirements by home and host regulators under Basel I, making compliance a very difficult “Catch-22”. While we have been able to resolve these issues to date, the potential tension between “home and host” regulators will become a bigger issue given the much wider and more detailed Basel II regime. If each country decides to require its own local rules and local data for each of the many calculations required under Basel II, the compliance burden will go from bad to worse. The Basel Committee has formed an Accord Implementation Group to deal with cross-border implementation issues, but experience shows that some differences between multiple supervisors are inevitable.

We are pleased to note that U.S. banking regulators have indicated a willingness to accept the Basel II approaches and calculations followed by a bank’s home country supervisors, when evaluating an international bank with U.S. branches and for purposes of eligibility of Gramm-Leach-Bliley Act financial holding company status. This is reassuring to hear. We hope that other host countries adopt similar policies that defer to home country regulators, and that similar issues related to subsidiary banks also are addressed.

For large international banks it is imperative that local host supervisors take account of the context of the whole organization. We have seen a tendency for regulators to require capital to be computed according to full Basel II standards in smaller subsidiaries, even though the draft Accord provides leeway and the assets and operating risks of those subsidiaries are consolidated, for Basel II Advanced purposes, at the holding company or parent level.

We believe that stronger proposals should be developed to resolve home/host country conflicts in a timely and more predictable manner. In particular, we believe practical benefits could be obtained by establishing a Committee of leading supervisors to understand large institutions with significant cross-border operations, and to resolve any interpretive problems under the Accord. There may also be some benefit from bilateral or multi-lateral home-host understandings between the U.S. and other national regulators to address specific institutions. We see such an approach today regarding the examination and supervision of a selection of internationally active institutions, including CSFB, and think that this experience can be directly applied to ensure a uniform and consistent implementation of the Accord.

Principles-Based Interpretation

Lastly, one of the critical elements of implementation of the Basel Accord will be the need for flexibility consistent with the concepts outlined in Pillar II of the Accord. The proposed Basel rules are based on the financial markets as they work today, but are so complex and heavily negotiated that they will be difficult to update over time. We strongly believe that regulators ultimately will need to place a renewed emphasis on the principles-based approach that underlies the Pillar II section of the proposed Accord, as a matter of either law or practice. Whereas Pillar I sets out regulatory capital calculations in a detailed, prescriptive way, the approach of Pillar II places a greater emphasis on the examination process and regulatory guidance to improve risk management practices.

This “principles-based” approach, subject to reasonable benchmarks and guidelines to maintain consistency, has some important natural advantages compared to Pillar I’s complex “black-letter” style. Pillar II encourages banks and regulators to work together over time to improve risk management practice, rather than forcing compliance with a potentially dated rulebook. That approach permits steady, evolutionary improvement to keep up with markets,

and should therefore be more durable and relevant than Pillar I rules that are designed with today's markets in mind. That approach should be acknowledged expressly in the final Accord. Pillar II is entirely consistent with the U.S. regulatory and examination process, but it is by no means standard practice in most other jurisdictions around the world. In order to have consistent implementation of the Basel rules across different jurisdictions, it will be critical that the U.S. regulators take an active role in communicating with other national regulators on the cooperative manner under which the Pillar II process will need to operate in practice, as a complement to the literal requirements of Pillar I.

Addressing the question of an evolving Accord over time will not be simple. If the rules are all applied as black letter law and interpreted strictly, the new rules will be both costly and – since the risk management advances that lead in part to Basel II will not end in 2005 – potentially irrelevant to ongoing best practice. One example of this relates to Operational Risk, an area that is relatively new in terms of a risk management discipline and quantification. There is a danger that certain approaches can be mandated as "best practice" by regulators in some jurisdictions, even though development in this area is far from complete. It is imperative we avoid new fixed requirements where they arise solely from the interpretations of the Accord by certain examiners.

We encourage an approach that emphasizes principles and simplicity as the rules are implemented, and a less burdensome "trust but verify" approach to compliance. Specifically, regulators will need to emphasize that compliance with the rules will be based not on "box checking" but with the spirit of the rules, based on economic principles.

Summary

We are at an important stage in the reform effort, perhaps the final leg of a long race. A lot of good hard work on designing the framework and gaining political consensus has been accomplished. We have a high regard for the efforts of the Basel Committee and the regulators who have worked so hard to capture the best current practices in risk assessment. CSFB and the Roundtable have tried to contribute to the specifics of those discussions in a constructive manner, and submit the three proposals we discussed today – trading book review implementation, cross border implementation, and principles based interpretation – in that light. We believe that refinements are still possible and that these changes will help to make the Accord more effective in practice.

As a final comment, I believe that regulators will need to look beyond the detailed calculations embedded in the rules, and focus on the overall quality, thoughtfulness, and integrity of a bank's risk management process to implement the Accord successfully. This places the burden back where it should be – on the shoulders of bank management - to demonstrate to the regulators and the public that they are doing a good job. That is in the spirit of the Sarbanes-Oxley reforms in the United States, and I think it is a smart, durable way to improve financial discipline and live up to the original goals of the Basel project.

Thank you.